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Mauritius: 2004 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Mauritius

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with Mauritius, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on April 1, 2004, with the officials of Mauritius on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 18, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of July 21, 2004 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 21, 2004 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Mauritius.

The document listed below has been or will be separately released.

Selected Issues Paper and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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MAURITIUS

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation with Mauritius

Approved by Juan Carlos Di Tata and Martin Fetherston

June 18, 2004

- The 2004 Article IV consultation discussions were held in Port Louis during March 19-April 1, 2004. The mission met with the Deputy Prime Minister and Minister of Finance, The Honorable Mr. Pravind Jugnauth; the Governor of the Bank of Mauritius, Mr. Rameswurlall Basant Roi; the Financial Secretary, Mr. Krishnanand Guptar; other senior government officials, and representatives of the private sector and trade unions.

- The staff team comprised Mr. McDonald (head), Mr. Yao, Ms. Kim, Mr. Mikhael, (all AFR) and Mr. Porter (FIN). Mr. Ismael (Advisor, Executive Director for Mauritius) also participated in the discussions.

- Mauritius is on the standard 12-month consultation cycle. At the conclusion of the 2003 Article IV consultation on June 30, 2003, Executive Directors noted that sound macroeconomic policies have established the conditions for investment and growth and the strong performance of the economy over the last two decades. Directors observed that the key challenges in the medium term will be to: (1) explore the scope for further economic diversification; (2) address the problem of persistent unemployment; and (3) contain the budget deficit and overall public debt in order to minimize the risks to medium-term macroeconomic stability.

- Mauritius accepted the obligations of Article VIII, Sections 2 (*a*), 3, and 4 on September 29, 1993, and its exchange system is free of restrictions on the making of payments and transfers for current international transactions. Mauritius also maintains a liberal capital account. It last availed itself of Fund resources in July 1986 and settled all repurchase obligations in May 1991. Since June 2002, Mauritius has been included as a creditor in the Fund's financial transaction plan.

- Appendix I presents an assessment of public and external debt sustainability. Mauritius's relations with the Fund, including technical assistance, are summarized in Appendix II, and its relations with the World Bank Group in Appendix III. The quality and timeliness of Mauritius's reporting of core data and other economic and financial statistics are, in general, satisfactory for conducting surveillance. Statistical issues are discussed in Appendix IV, progress toward the Millennium Development Goals in Appendix V, and a draft PIN is included in Appendix VI.

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EXECUTIVE SUMMARY

Following a weak growth performance in 2002/03 (July-June), real GDP is expected to have increased by around 4½ percent in 2003/04, largely reflecting the recovery of sugar production and strong construction activity. The overall fiscal deficit is estimated to have declined slightly to 5½ percent of GDP in 2003/04, and the external current account surplus to have remained unchanged at about 2½ percent of GDP. Inflation is expected to decline to around 4 percent by the end of the fiscal year.

Real GDP growth is projected to remain under 5 percent in 2004/05, and medium-term growth is likely to slow to around 4 percent per annum. While moderate growth is expected in the tourism, information and communications technology (ICT), and sugar sectors, the textile sector is expected to decline further.

Mauritius's immediate and medium-term challenges are threefold. First, there is a need to diversify and transform the economy, especially in light of the expected loss of trade preferences in the sugar and textile sectors. Second, the authorities must undertake structural reforms to lessen labor market rigidities. Third, persistent budget deficits need to be reduced if medium-term fiscal sustainability and macroeconomic stability are to be preserved.

Medium-term fiscal consolidation is essential to avert unsustainable debt dynamics that could jeopardize the economy's growth prospects and macroeconomic stability. The government should aim to stabilize the public debt/GDP ratio in 2004/05 by reducing the deficit to around 4¾ percent of GDP. Reductions in the fiscal deficit of around 1 percent of GDP annually in subsequent years would reduce the public debt/GDP ratio to around 66 percent by 2007/08, from above 70 percent in 2003/04. Sustainable fiscal policy would need to be accompanied by prudent monetary and exchange rate policies to protect the economy from downside risks.

In line with the FSAP recommendations, the authorities have taken steps to strengthen the financial system. The government is expected to pass draft laws to revise the Bank of Mauritius Act and the Banking Act at around the time of the announcement of the 2004/05 budget. The authorities have also taken a number of actions to strengthen the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework.

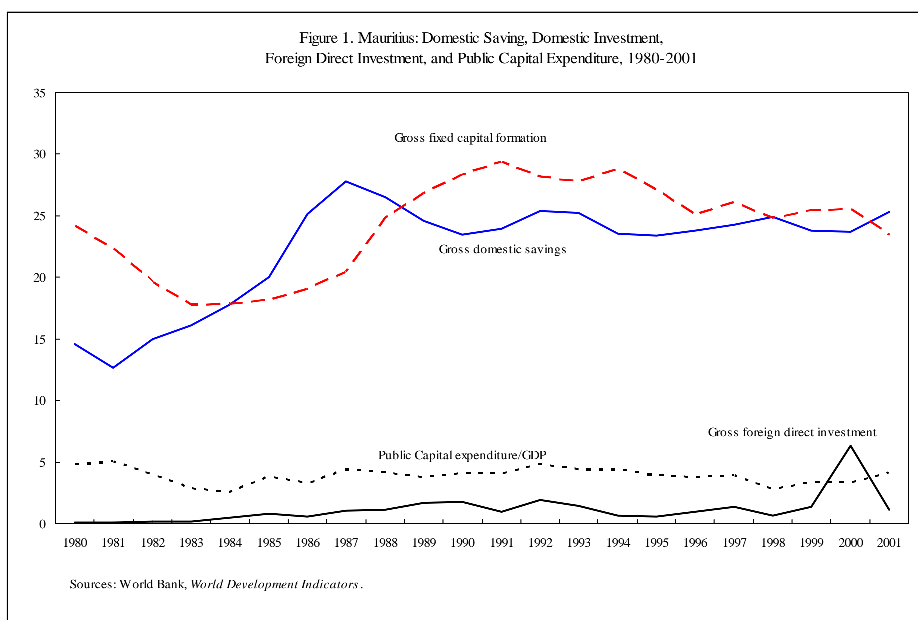
I. Introduction and Medium-Term Challenges

1. **Mauritius's social and economic success during the past quarter century has been impressive.** This success owes much to the high quality of institutions, including a well-functioning multi-party democracy, an independent judiciary, and a strong sense of the "rule of law."[1] Good institutions and appropriate policies have led to a more than doubling of per capita income, a narrowing of income disparities, and a marked improvement in social indicators. Since the early 1990s, however, unemployment has risen steadily, owing to labor market rigidities and a structural skills mismatch.

2. **Remarkably, Mauritius's development has been financed almost entirely from domestic savings,** which have been intermediated through an efficient domestic banking system. Foreign Direct Investment (FDI) has played a minor role (Figure 1).

3. **Mauritius's immediate and medium-term challenges are threefold.** First, there is a need to diversify and transform the economy, especially in light of the expected loss of trade preferences in the sugar and textile sectors. Second, Mauritius must undertake structural reforms to increase labor market flexibility. Third, persistent budget deficits need to be reduced if medium-term fiscal sustainability and macroeconomic stability are to be preserved.

Figure 1. Mauritius: Domestic Saving, Domestic Investment, Foreign Direct Investment, and Public Capital Expenditure, 1980-2001



Sources: World Bank, *World Development Indicators*.

[1] According to the 2003 reports of the World Economic Forum and Transparency International, Mauritius is among the top five African countries for quality of public institutions and perception of corruption.

4. **While the timing of the phasing out of textile preferences has been defined, there is less certainty in the case of sugar exports**. Textile quotas will be phased out with the expiration of the WTO Agreement on Textiles and Clothing (ATC) in January 2005. Given its relatively high per capita income, Mauritius does not qualify for the third-country fabric provision under the U.S. African Growth and Opportunity Act (AGOA). Therefore, unlike other nations benefiting from preferential access to the U.S. market under AGOA, Mauritius cannot import raw fabric from non-AGOA countries, placing the country at a relative disadvantage. The preferential access afforded to sugar exports by the European Union (EU) is currently under review.[2]

5. **Mauritius's unemployment has increased rapidly since 1991 primarily among low-skilled workers** concentrated in the sugar and textile sectors.[3] Unless significant labor market reform takes place, the unemployment rate may worsen in coming years.

6. **While external debt remains at a relatively low level, domestic public debt sustainability is a major concern.** According to sensitivity tests carried out by staff, total public debt could become unsustainable in the medium-term in the absence of significant fiscal adjustment, thereby jeopardizing growth prospects and macroeconomic stability.

7. **The authorities' response to the challenges identified in Fund surveillance in recent years has been uneven.** For example, while some attempt was made to enhance prospects for medium-term fiscal sustainability in 2002/03 through the introduction of revenue-enhancing measures, the tax base remains relatively narrow. The authorities have also been slow to address key structural reforms, particularly with respect to the labor market and the strengthening of the fiscal position of key state-owned enterprises. However, in the last year, some progress was made in addressing the challenges identified by Executive Directors during the 2003 Article IV consultation. Specifically, the authorities have**:** (i) attempted to revitalize the sugar and textile sectors through the implementation of cost-saving measures in the former and the facilitation of the restructuring of viable firms in the latter; (ii) made a number of improvements in line with the FSSA recommendations, and issued guidance notes on AML/CFT; (iii) implemented an automatic pricing mechanism for petroleum products; and (iv) introduced the Bank of Mauritius (BOM) Bill to control liquidity in the banking system. Undertaking further reforms in the near term will prove difficult and will require a strong commitment by the authorities, especially in light of upcoming elections (Box 1).

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[2] The WTO recently convened a panel to consider the challenge to the EU's sugar export subsidies brought by Australia, Brazil, and Thailand.

[3] The 2000 Census reported that 90 percent of the unemployed have not completed the high school certificate.

Box 1. Political Developments

Mauritius has a multiparty democratic system. The transfer of the premiership took place on September 29, 2003, in line with a coalition agreement reached in 2000 between the Mouvement Socialiste Militant (MSM) of Sir Anerood Jugnauth and the Mouvement Militant Mauricien (MMM) of Mr. Paul Bérenger. As a result, Mr. Bérenger relinquished the finance portfolio to become the new Prime Minister to complete the final two years of the five-year term of office, while Sir Anerood gave up the premiership and became president. The new MSM leader, Mr. Pravind Jugnauth—son of the president—is the new deputy prime minister and finance minister. The opposition Labour Party's victory in the December 2003 by-election for the National Assembly seat vacated by Sir Anerood has given new impetus to opposition activities. The next general election will take place in 2005.

II. Recent Economic Developments

8. **Real GDP growth is expected to rebound to around 4½ percent in 2003/04 (July-June), following a disappointing 2¾ percent in 2002/03**. This largely reflects the recovery of tourism and sugar production, the latter due to favorable weather, and continued strong construction and transportation activity. However, high domestic production costs and increased competition have continued to affect adversely the Export Processing Zone (EPZ) sector, which registered negative growth for the second consecutive year. The unemployment rate rose to 10.2 percent in 2003, from 9.7 percent in 2002.

9. **Budget execution for the first eight months of 2003/04 (July-February) was broadly in line with the target of reducing the deficit to 5.5 percent of GDP, from 6.2 percent in 2002/03**. This improvement reflects primarily higher tax and nontax revenue. Total expenditure remained broadly unchanged at 26½ percent of GDP.

Central Government Finances, 1999/00-2003/04 1/
(In percent of GDP)

	1999/00	2000/01	2001/02	2002/03	2003/04 Rev. Budg. Est.
Total revenue and grants	20.9	18.2	18.4	20.3	20.9
Tax revenue	18.1	16.1	15.7	17.4	17.8
Nontax revenue and grants	2.8	2.0	2.7	3.0	3.1
Total expenditure and net lending	24.7	23.9	24.4	26.5	26.4
Of which: Current expenditure	20.8	21.4	20.3	21.2	21.2
Capital expenditure	3.0	3.1	3.7	4.7	4.8
Net lending	0.1	-1.3	0.4	0.7	0.4
Overall balance	-3.8	-5.7	-5.9	-6.2	-5.5
Primary balance	-0.4	-1.3	-2.6	-1.9	-1.5

Sources: Ministry of Finance; and IMF staff estimates and projections.

1/ Fiscal year from July to June.

10. **There is a danger that public debt could become unsustainable as a result of continuing central government fiscal deficits.** The total public debt, which was equivalent to 66 percent of GDP in 1999/00, rose to about 80 percent in 2002/03. At the same time, the debt service burden rose by over 40 percent from 2001/02 to 2002/03, accounting for a large share—20 percent—of current expenditure. Moreover, with most of the debt concentrated in short-term

securities, there is significant rollover and interest rate risk. Recognizing these risks, in 2003/04 the government has mostly financed its budget deficit by drawing on its deposits at the BOM. External public debt remains relatively low at a projected 19 percent of GDP in 2003/04.

11. **The overall balance of 30 nonfinancial public sector corporations shifted from a deficit of 0.6 percent of GDP in 2001/02 to a surplus of 0.9 percent in 2002/03.**[4] The Central Electricity Board (CEB) continues to face financial difficulties, in part because of its inability to pass on to consumers the higher international price for fuel oil—a major input in electricity generation. The financial position of the State Trading Corporation (STC) is expected to improve following the introduction in early April 2004 of an automatic mechanism for adjusting the prices of petroleum products.[5]

Selected Economic and Financial Indicators, 1999/00-2003/04 1/

	1999/00	2000/01	2001/02	2002/03 Prov.	2003/04 Est.
	(Annual percentage changes, unless otherwise indicated)				
GDP at constant market prices	2.7	7.6	4.3	2.7	4.4
Consumer prices (period average)	5.3	4.4	6.4	5.1	3.9
Unemployment rate (in percent)	7.7	8.8	9.1	9.7	10.2
Real effective exchange rate 2/	5.7	2.7	-1.9	-1.0	0.8
	(In percent of GDP at market prices)				
Overall fiscal balance (including grants)	-3.8	-5.7	-6.0	-6.2	-5.5
External current account balance	-1.6	3.4	5.4	2.6	2.6
Total public debt	65.8	64.4	70.5	80.5	72.8
Net international reserves of the Bank of Mauritius 3/					
(In months of prospective imports, c.i.f.)	4.1	5.0	5.4	6.9	7.5

Sources: Mauritian authorities; and Fund staff estimates.

1/ Fiscal year from July to June.

2/ Trade-weighted period averages (a negative sign signifies a depreciation). Figure for 2003/04 represent the percentage change from July to December 03.

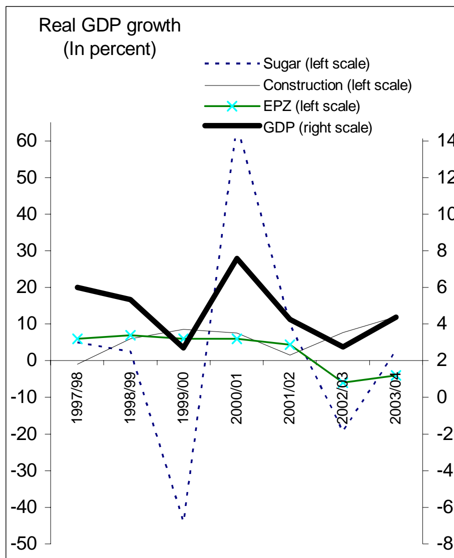
3/ In months of imports, c.i.f.

[4] There is insufficient information available to prepare projections for the public corporations for 2003/04.

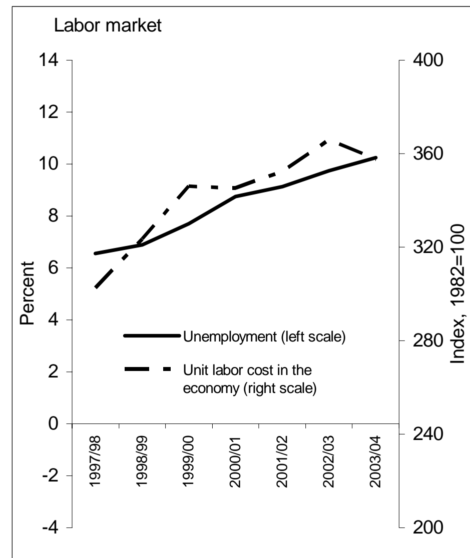
[5] This has led to increases of 4.6 and 9.6 percent in gasoline and diesel prices, respectively, since April 2, 2004.

Figure 2. Mauritius: Real Sector Developments

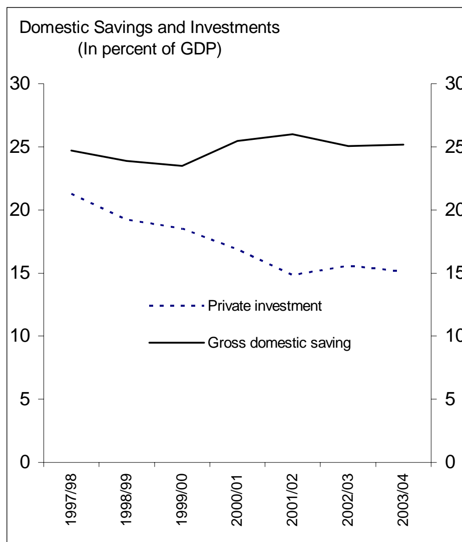
Real GDP growth is expected to rebound, supported by the sugar and construction sectors, but the EPZ sector remains weak.



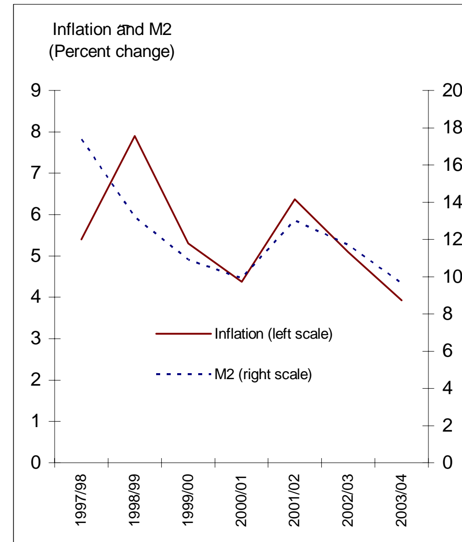
Unemployment continued to rise in line with high cost of labor.



Savings remained high, while private investment fell...



...and inflation declined.



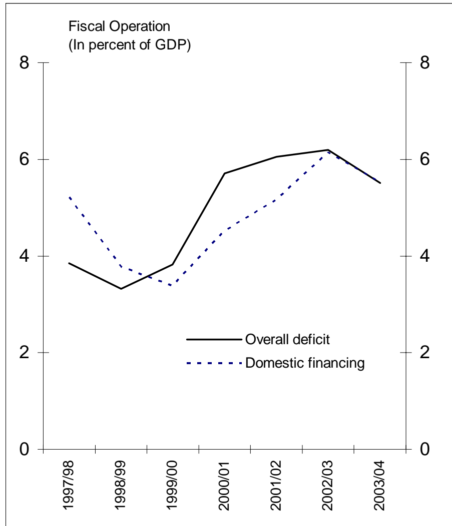
12. **Low and stable inflation has generally been achieved, largely due to a relatively successful implementation of an informal inflation targeting framework.** Average annual inflation fell to around 4 percent in 2003, from 6.4 percent in 2002, in line with the central bank's inflation target. The growth of credit to the private sector slowed in 2003, owing in part to the weaker performance of the textile sector. The outlook is for a further moderate fall in inflation over the near term, as demand pressures remain subdued.

13. **Key interest rates have been trending downward over the last two years, although real lending rates remain high.** The BOM lowered its Lombard rate in five steps by a total of 200 basis points, to 9½ percent in late January 2004. These actions reflect the judgment that inflationary risks have subsided, and a desire to provide a stimulus to economic activity. However, given the weaknesses in key sectors of the economy, banks have been cautious in advancing credit to segments of the private sector. This, together with the drawdown in government deposits, which has not been fully sterilized by the BOM, has led to a situation of excess liquidity in the banking system. As a result, interest rates in the interbank market have fallen to an all-time low of less than one percent at end-March 2004, leading to a steepness at the short end of the yield curve. Declining inflationary expectations over the last two years have led to a gradual decline in interest rates, resulting in a reduction in the differential between the yield curve of Mauritius and that of the U.S.

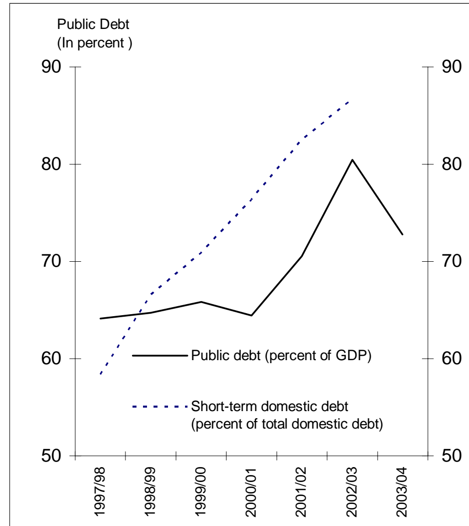
14. **The overall balance of payments surplus is projected to decline from 6½ percent of GDP in 2002/03 to below 2 percent in 2003/04.** The current account is projected to remain in surplus in 2003/04, with a recovery of the tourism sector offsetting a widening in the trade deficit. The capital and financial account is projected to register a small deficit of 0.8 percent of GDP in 2003/04, compared with a surplus in 2002/03. FDI flows are expected to weaken in 2003/04.

Figure 3. Mauritius: Fiscal Developments

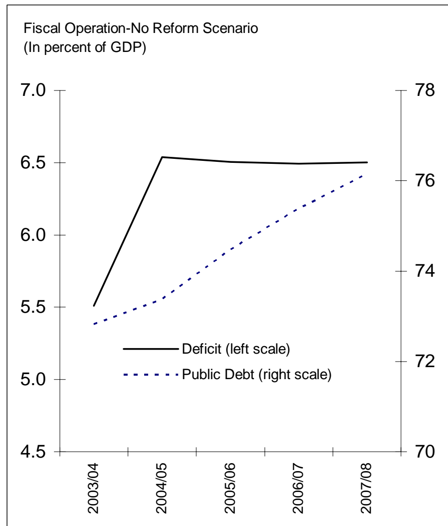
Fiscal imbalances have reemerged since 2000/01, and have largely been financed domestically.



This has resulted in mounting public debt, mostly short-term bills.



Without fiscal consolidation, there is danger that the public debt could become unsustainable...



...as debt servicing becomes an increasing proportion of current expenditure.

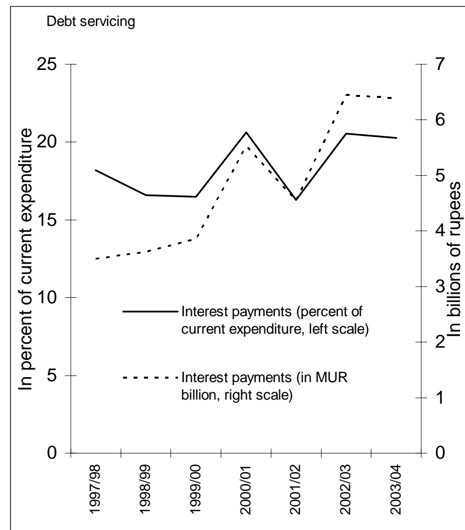
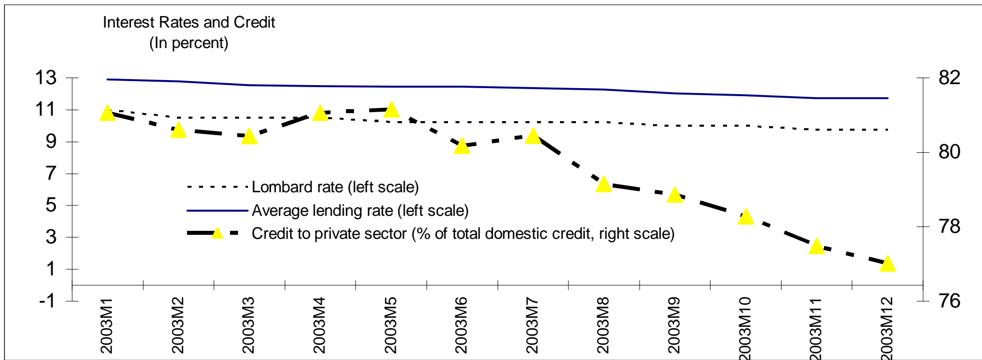
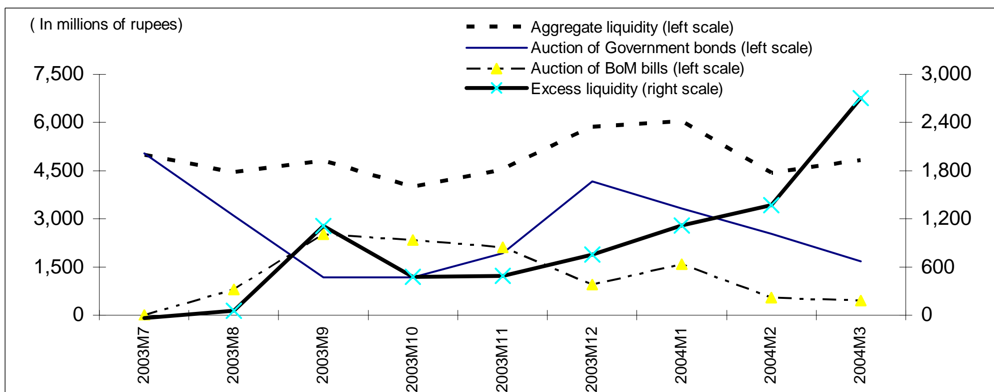


Figure 4. Mauritius: Monetary Developments

The BOM lowered Lombard rates to stimulate activity, but credit to the private sector was sluggish.



Together with the drawdown in government deposits, there is excess liquidity in the banking system...



The differential between the U.S.'s and Mauritius's yield curves has narrowed over the last two years.

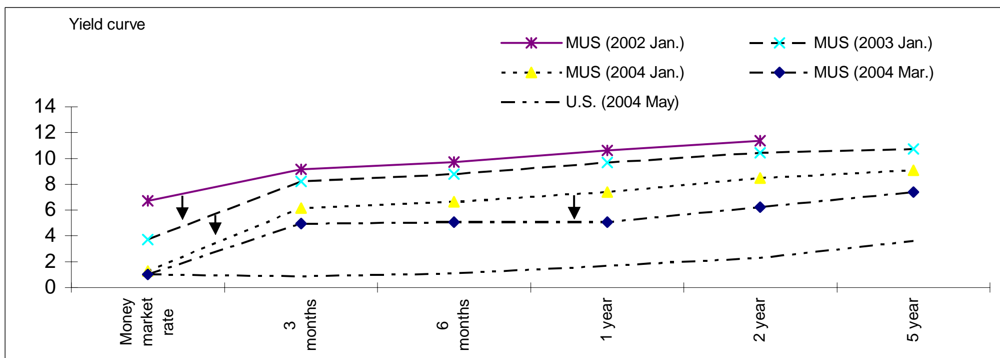
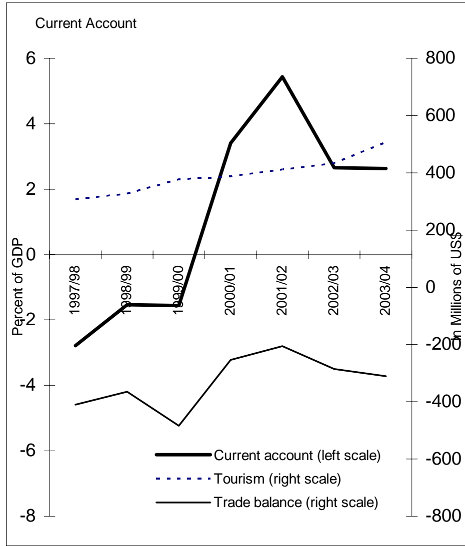
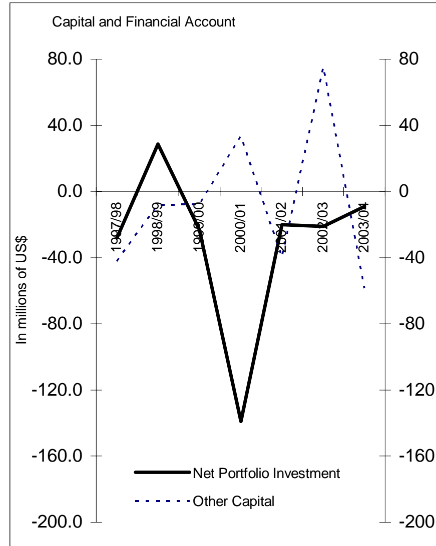


Figure 5. Mauritius: External Developments

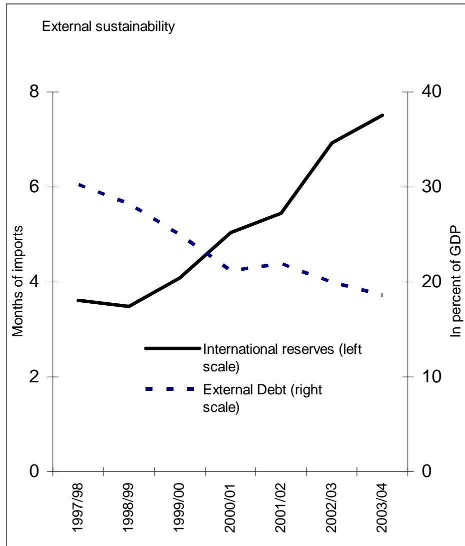
Current account surplus is expected, as increased receipts from tourism offset the widened trade deficit.



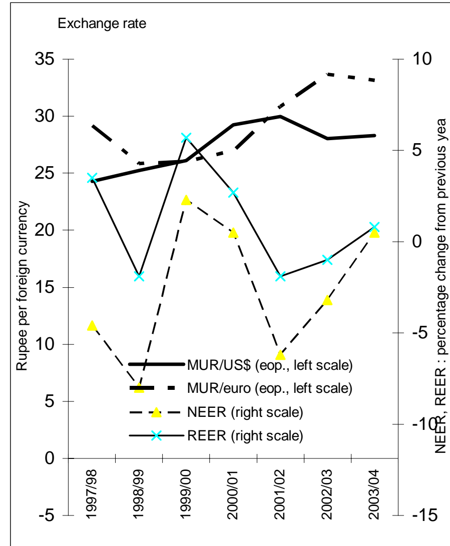
Net portfolio inflows recovered, while other capital inflows declined.



International reserves continued to rise, while external debt declined...



...and the government allowed the rupee to appreciate (depreciate) against the US dollar (euro).



III. Report on Policy Discussions

15. **The policy discussions centered around the medium-term challenges of diversifying the economy and preserving fiscal sustainability and macroeconomic stability**. The main focus was on: (i) the authorities' medium-term strategy to improve the competitiveness of the economy and strengthen growth prospects; (ii) the budget performance in 2003/04, fiscal polices for 2004/05, and medium-term fiscal consolidation; and (iii) the appropriateness of monetary and exchange rate policies.

A. Medium-Term Growth Sources and Prospects

16. **The economy is expected to grow by about 4¾ percent in 2004/05, largely led by a continued recovery in sugar production.** Tourism is expected to strengthen further, reflecting an increase in visitor arrivals from the U.K. and India, while the expansion in the construction sector should continue with the building of several new hotels. Other sectors that are expected to contribute to growth include wholesale and retail trade, transport, information and communications technology (ICT), and financial services. However, the outlook for exports from the EPZ sector remains weak, with several large textile firms in the process of relocating their operations to China in anticipation of the ending of the quota system governing world trade in textiles.

17. **Medium-term growth is expected to slow to around 4 percent per annum—significantly below the average of almost 6 percent over the past three decades.** This reflects a weaker outlook for the traditional pillars of the economy—sugar and textiles (Box 2)—and the effects of persistent rigidities in the labor market. New sectors, such as the ICT sector, are expected to contribute increasingly to growth but their starting point is low.

18. **The authorities expressed concern about the medium-term prospects for the real economy, and indicated that they were taking steps to improve the outlook for the traditional sectors while creating an environment conducive to the development of other sources of growth.** The authorities have been preparing for the potential loss of preferences for sugar by implementing reforms to reduce gradually production costs. Major reforms have been the introduction of a voluntary retirement scheme, which has resulted in an almost 30 percent reduction in the workforce (7,900 employees), and the consolidation of milling operations. Efforts are also under way to diversify sugar-related activities, including the production of electricity as by a product of the sugar sector for sale to the national electricity company, and rum and ethanol production. The mission encouraged the government to intensify these efforts and to complete an ongoing mid-term review of the sugar sector strategy.

19. **The authorities also indicated that they were assisting the restructuring of the textile sector through technical advice and development finance.** The government remains hopeful that AGOA's third country fabric provision will be extended to Mauritius in the near future. However, many Hong Kong-based textile firms, which account for about 25 percent of textile employment and 30 percent of exports are likely to leave Mauritius in the

Box 2. Growth Impact of the Elimination of Trade Preferences[1]

The baseline growth projection for the medium term is 4 percent per annum. In 2004/05, this scenario envisages a growth rate of 4.8 percent based on an increase in sugar production of 16 percent following a bumper crop in 2004, and a decline in the EPZ sector of 3.5 percent. However, sugar production is expected to decline the following year. The weak performance of the sugar and EPZ sectors is expected to continue into the medium term, reflecting increased global competition, a reduction in the area used for sugarcane production, and a gradual disinvestment of some foreign textile companies. These developments are expected to be balanced by the capability of the Mauritian economy to adjust partially to the changing international business environment through the restructuring of the economy and the development of other sources of growth, including in the ICT and the financial services sectors.

The baseline scenario, however, faces several downside risks. Structural reforms could take longer than expected; and the shocks to both the sugar and textile sectors could be even more severe. This will depend on the resolution of the challenge to the EU sugar subsidies by Australia, Brazil, and Thailand and developments in the textile market during the post-ATC period.

In a *moderately adverse* scenario, the shocks are expected to have a more substantial but gradual impact in the next three years. Sugar prices are assumed to fall to US$0.16 per pound in 2005, and further to US$0.10 per pound in 2007. The textile sector would shrink by 8 percent in 2004/05, 15 percent in 2005/06, and 8 percent in 2006/07, stabilizing thereafter. The impact of this scenario, relative to the baseline, would be to reduce GDP growth by about ¾ of a percentage point in 2004/05, 1½ percentage points in 2005/06, and ½ a percentage point in 2006/07.

In an *extremely adverse* scenario, the shocks would have a much stronger impact on the different sectors of the economy. One assumption—although with low probability—would be for the WTO panel to decide on the complete liberalization of sugar trade starting in 2005. This would most likely cause sugar prices to drop to around US$0.10 per pound. The other assumption is a more dramatic impact on the textile sector following the phasing out of the ATC preferences. This could lead to the closure of all textile firms categorized as either vulnerable or at risk under the Textile Emergency Support Team (TEST) initiative, in addition to the relocation of foreign and some local companies to cheaper production sites. The impact on the textile sector would be a decline of between 20 and 30 percent in 2004/05 and 2005/06. This scenario would lead to a reduction in the baseline medium-term growth projection by an average of between 2-2½ percentage points a year.

1/ Please see accompanying selected issues paper.

next two to three years, owing to rising labor costs[6] and the removal of quotas that currently constrain exports from countries such as China. This would increase the already high unemployment rate, and its incidence among low-skilled workers (see Box 3).[7] The mission welcomed the establishment of the Textile Emergency Support Team (TEST), which is designed to facilitate the rehabilitation of viable textile enterprises through the provision of corporate diagnosis services and the consolidation and streamlining of various initiatives. These initiatives include the provision of financial resources from the National Equity Fund for capitalization and spinning activities, as well as enterprise modernization schemes supported by the Development Bank of Mauritius.[8] The authorities agreed that there is a need to intensify the retraining of displaced textile workers so that they can be absorbed by other sectors.

20. **Notwithstanding prevailing uncertainties, the authorities were optimistic about the growth prospects for the tourist sector.** Plans are being implemented to construct about 20-25 hotels (representing additional capacity of about 40 percent) in the next three years. This increase in capacity, however, is coming at a time when the hotel occupancy rate has declined. More generally, a consistent strategy needs to be developed to market Mauritius as a tourist destination, since the envisaged rapid expansion may conflict with preserving the country's image as an "upper-end" tourism product. Moreover, issues related to the expansion of air access may need to be resolved in order to increase tourist arrivals.

21. **The government continues to view the emerging ICT sector as providing a new source of growth for the economy over the medium term.** Nonetheless, the mission noted that the outlook for the sector appeared less favorable than a year ago, owing to considerable global competition. The authorities indicated that, based on current commitments, the recently completed cyber tower will have an occupancy rate of around 40-60 percent during the first year, and that 3,000 new jobs would be created by end 2004. However, significant uncertainty remains, as many Indian firms that initially expressed interest in establishing operations in Mauritius seem to have changed their plans.

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[6] Hourly textile labor costs in Mauritius are three times those of Pakistan, and more than twice those of China, India, and Madagascar.

[7] See also the accompanying selected issues paper on labor market issues.

[8] The mission also supported the establishment of the Corporate Debt Restructuring Committee, which will oversee the restructuring of the debts of those firms found to be viable. This committee has been established under the auspices of the TEST, and is chaired by the Managing Director of the BOM.

Box 3. The Mauritius Labor Market[1]

Reforms in Mauritius's labor market should include the introduction of decentralized wage bargaining and the elimination of restrictions on worker redeployment and terminations.

The labor market is highly regulated, with restrictions on the redeployment of workers, wages and benefits, and terminations. The government establishes a separate set of labor market regulations—which specify the duties and wages of each narrowly defined occupation—for most industries, which inhibits the ability of firms to redeploy workers.[2] The annual tripartite wage setting process typically indexes economy-wide wage growth to inflation, while terminations tend to be both costly and time consuming, usually requiring approval by the Termination of Contracts of Services Board.

In addition to the relatively high unemployment, unemployed workers are facing exceptionally long spells—with an average unemployment duration of 20 months—and a **less dynamic labor market**, with relatively low quarterly job creation.

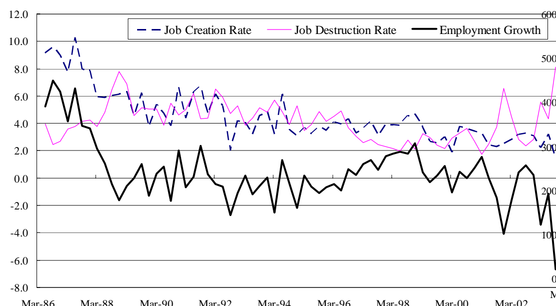
Moreover, the highly regulated nature of the labor market unnecessarily reduces the employment opportunities for low-skilled workers. By increasing the relative wages paid to low-skilled workers, these regulations reduce the incentive to create new jobs and make existing jobs more insecure. Limits on the ability of firms to redeploy workers have similar effects, while restrictions on terminations reduce the incentives to create new jobs. Although these restrictions in particular do not apply to some key sectors—such as the EPZ sector—they inhibit the creation of new jobs for low-skilled workers in other areas. This differential regulatory treatment will become increasingly important as the economy adjusts to the loss of trade preferences.

Structural changes in the market for low-skilled workers may already be becoming apparent. The first figure below shows that 2002-03 constitutes a period of historic weakness in EPZ employment, mainly driven by a sharp rise in the rate of job destruction. Moreover, there has been a sharp rise in the average size of EPZ firms closing down.

1/ Please see accompanying selected issues paper.

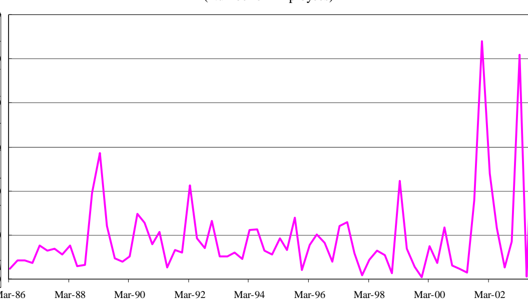
2/ These regulations do not cover the EPZ sector, and are not expected to cover new ICT activity.

Decomposition of Quarterly EPZ Employment Growth, 1986-2003 1/



1/ Seasonally Adjusted.
Source: Fund staff estimates and Central Statistical Office, Mauritius.

Average Size of Closing Firms, 1986-2003
(Number of Employees)



Source: Fund staff estimates and Central Statistical Office, Mauritius.

B. Structural Reforms

22. **In addition to the sectoral issues described above, the discussion on structural reforms focused on the labor market and private sector involvement in the economy.** The mission urged the authorities to move ahead with labor market reforms. The government noted that comprehensive measures had been taken to overhaul the education system in order to increase the access of students to educational facilities, and to improve the quality and relevance of the curriculum at all levels, especially at the secondary school level. Staff acknowledged that these reforms would help alleviate the skills mismatch, but stressed that other important factors affecting the labor market also needed to be addressed. In particular, the mission favored the adoption of firm-level wage bargaining and the simplification of the numerous regulations governing the ability of firms to redeploy and terminate workers. The authorities agreed on the importance of reforming the various labor market institutions, but indicated that it was difficult to carry out substantive changes during an election year. Trade union representatives acknowledged that there was some need for improving labor market flexibility, but cited the importance of wide-ranging consultation among all stakeholders.

23. **The authorities recognize that the benefits of labor market reforms are likely to materialize only over the medium to long term.** They expressed concern about the present high unemployment rate and its large component of unskilled workers. While there is evidence that the income of this group is being supported to a large extent by informal household transfers, the authorities and staff agreed that additional measures, such as public work programs and training, should be considered to ameliorate their situation.

24. **The mission encouraged the authorities to promote further private sector participation in the economy, including foreign direct investment.** Private sector development could be enhanced by reducing state involvement in commercial activities, such as electricity, and the importation of petroleum products, rice, and cement. The authorities were of the view that the small size of the domestic market and relatively high labor costs constrained FDI flows. The mission welcomed the draft bill designed to facilitate public-private sector partnerships in infrastructure investments. This initiative will enhance prospects for domestic and foreign direct investments and will relieve the burden on the budget to finance large investment projects.

C. Fiscal Policy

25. **The fiscal policy discussions focused on addressing persistent deficits and their impact on medium-term debt sustainability.** Without significant policy reform, the fiscal deficit for 2004/05 is expected to rise to about 6½ percent of GDP. If the fiscal deficit remains at this level over the medium term, public sector debt could rise to over 76 percent of GDP by 2007/08. [9] The mission proposed a medium-term path to reduce gradually the deficit

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[9] In this case, public finances would become significantly vulnerable, and the debt could exceed 100 percent of GDP by 2007/08 under a combination of plausible negative shocks.

to 2 percent of GDP by 2007/08, which would allow the public debt to fall to about 64 percent of GDP by the end of the period. Sensitivity analysis shows that when deficits are reduced, public sector debt would also be resilient to external shocks and would quickly return to a stable level, even in the event of a combination of temporary interest rate and output shocks. Consistent with the proposed medium-term path, the mission proposed that the authorities reduce the fiscal deficit to 4.7 percent of GDP in 2004/05.

26. **On the revenue side, the mission suggested a number of measures for 2004/05.** These included: (a) broadening the income tax base; and (b) applying the VAT to some items that are currently exempted or zero rated. The mission reiterated the need to include a number of fringe benefits in taxable income, subject interest and dividend income to a withholding tax, and reduce the generous allowance for capital investment. Staff also recommended broadening the base of the VAT to cover electricity and processed and nonraw foods. These reforms, together with some other nontax measures, could yield some 0.7 percent of GDP in 2004/05.

27. **Regarding expenditure, the mission highlighted the need to prioritize spending, and to review the effectiveness and coverage of the current generalized subsidies on rice and flour.** In addition, the mission suggested: (i) further trimming of the capital budget and phasing some projects over the next several years; and (ii) lengthening the maturity structure of the domestic debt (Box 4). Regarding the latter, the staff urged the government to create a debt management unit. The proposed lower primary deficit would reduce the borrowing requirement of the budget and lower interest payments. A restructuring of domestic debts would also significantly reduce interest costs for the following reasons. First, the fall in the level of the yield curve means that the interest cost of lengthening the maturity of previously accumulated debt—especially given the large issuance of 2-year bonds in 2002/03—will lead to substantial savings. Second, a further moderation of inflationary expectations, and more subdued long term growth, should be accompanied by a further fall and flattening of the yield curve over the coming years, leading to interest savings on newly accumulated debt. Overall, the proposed expenditure measures could save 1.1 percent of GDP.

28. **The authorities were in general agreement with the proposed fiscal measures, but they acknowledged that there would be political resistance to some of them**. They welcomed the revenue proposals and indicated that they were also considering to set up an independent Revenue Authority in line with recent recommendations from an FAD technical assistance mission. As to expenditure policy, the authorities indicated that they were receiving support from the World Bank and the U.S. Treasury to develop a Medium-Term Expenditure Framework. While they agreed in principle to the targeting of subsidies, they noted that reducing these subsides may be difficult in light of the upcoming election. Moreover, the authorities were of the view that putting in place an efficient system of direct transfers would take time and be administratively challenging. They also indicated that they were planning to postpone some capital projects that would save about MUR 500 million (0.3 percent of GDP) in 2004/05. To mitigate the effect of a bunching of maturing treasury bills in 2004/05, the authorities are in the process of implementing a strategy to restructure the debt into longer maturities.

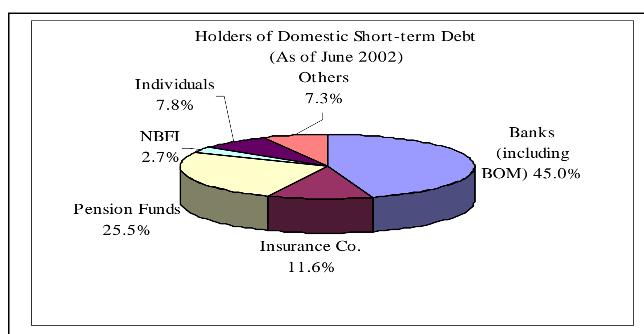
Box 4. Domestic Public Debt in Mauritius[1]

The increase in Mauritius's public debt can be attributed primarily to: (i) fiscal imbalances that emerged since the late 1990s as the government invested heavily in education and infrastructure for the new ICT sector; and (ii) the issuance of treasury bills for monetary policy purposes. The BOM only began issuing central bank bills as a monetary policy tool in July 2003.

Government Debt Profile (as of end of fiscal year, in millions of MUR)

	1998/99	1999/00	2000/01	2001/02	2002/03
Long Term					
Treasury Certificates	0.0	0.0	0.0	0.0	0.0
Tap Loan Stocks	0.0	0.0	0.0	0.0	0.0
Development Loan Stocks	11,340.0	11,590.0	12,710.0	11,807.8	11,408.0
Anonymous Bearer Bonds	0.0	0.0	0.0	0.0	0.0
8-Year Savings Bonds	0.0	0.0	0.0	0.0	0.0
4-Year Independence Bonds	296.4	0.0	0.0	0.0	0.0
5-Year Republic Bonds	2,078.5	2,078.5	0.0	0.0	0.0
Treasury Bearer Bonds	0.0	0.0	0.0	0.0	0.0
5-Year GOM Bonds	0.0	0.0	0.0	0.0	866.3
sub total	13,714.9	13,668.5	12,710.0	11,807.8	11,408.0
In percent of GDP	12.9	12.1	10.2	8.6	7.7
Short Term					
Treasury Bills(nominal)	24,097.4	32,188.2	41,034.9	55,607.0	74,662.2
1-Month	860.4	0.0	0.0	0.0	0.0
3-Month	3,299.0	4,018.0	1,582.9	2,051.3	911.9
6-Month	4,484.1	6,875.5	3,414.3	3,887.4	3,521.8
12-Month	6,339.0	8,153.8	16,070.0	14,807.2	14,700.0
24-Month	9,114.9	13,140.9	19,967.7	34,861.1	55,528.5
Advances from B.O.M.	3,161.5	1,089.4	0.0	0.0	0.0
Tax Reserve Certificates	0.5	0.4	0.4	0.4	0.4
sub total	27,259.4	33,278.0	41,035.3	55,607.4	74,662.6
In percent of GDP	25.7	29.5	32.8	40.5	50.1
TOTAL	40,974.3	46,946.5	53,745.3	67,415.2	86,070.6
In percent of GDP	38.6	41.7	43.0	49.1	57.8

A large part of the public debt is in short-term maturities and is largely held by banks.[2] This concentration of short-term debt exposes the government to interest rate and rollover risk. The persistent fiscal deficits and the weak state of debt management has resulted in interest payments rising by over 40 percent between 2001/02 and 2002/03. The authorities are burdened with a major rollover of treasury bills amounting to about MUR 40 billion (24 percent of GDP) in 2003/04, compared with MUR 50 billion (33 percent of GDP) in 2002/03.



The government is in the process of setting up a Debt Management Unit within the Ministry of Finance and is seeking to convert much of the short-term debt to longer term bonds, while smoothing future interest payments. However, unless the fiscal deficit is significantly reduced, lengthening the maturity structure would only postpone the debt problem.

Interest Payments and Rollover of Domestic Debt, 2001/02-2004/05
(In million MUR, unless otherwise indicated)

	2001/02	2002/03	2003/04	2004/05
Interest payments on total government domestic debt	4,333.9	6,202.0	6,405.0	6,850.0
(In percent of current expenditure)	15.5	19.7	18.5	18.5
Interest payments on T Bills	3,108.0	5,076.6	5,177.7	6,639.8
Rollover of T Bills		49,974.3	39,865.3	29,161.0
(In percent of GDP)		33.5	24.4	16.4

1/ Excluding pension fund debt.

2/ Short-term securities are mostly held by the banks (including the BOM), while nonbank financial institutions are the major holders of longer-term bonds.